NOTES

THE PROPERTY CONCEPT IN THE CALCULATION OF PERCENTAGE DEPLETION: THE DISJUNCTION OF THE 1954 AGGREGATIONS

During the infancy of the oil and gas industry, the federal government was sympathetic to its problems and needs. Congress, recognizing the unusual risks involved in the discovery of the deposits of these natural resources as well as the vast amounts of capital required for such ventures, desired to make special concessions to the industry to encourage its expansion and improvement. Prior to 1926 the producers of oil and gas employed cost and discovery depletion in calculating their taxable income to take into account the diminution in value of their investments resulting from the exhaustion of the natural resources through current operations.[1] Discovery depletion permitted the producers not only to recover their costs but also to receive an allowance which would be available for reinvestment in the industry.[2] The Internal Revenue Service, however, found it difficult to compute or to verify discovery depletion.

Congress, to eliminate the difficulties of discovery depletion, adopted the method of percentage depletion which has been in effect since 1926.[3] The percentage depletion allowance permits a producer of oil and gas to deduct twenty-seven and one-half per cent of the gross income *from the property*[4] without regard to its economic cost. This amount cannot exceed fifty per cent of the taxable income *from the property* before the allowance for depletion, but the deduction shall not be less than the amount computed on the cost basis.[5] Therefore, a taxpayer can always recover his cost and may recover a greater amount through the percentage depletion allowance.

Of primary importance in determining the permitted allowance is a complete understanding of the term "property" as used in the Internal

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1 Revenue Act of 1918, ch. 18, § 214(a)(10) (as to individuals), § 234(a)(9) (as to corporations), 40 Stat. 1066, 1077.

2 The statutory rules concerning discovery depletion are discussed in 4 MERTENS, FEDERAL INCOME TAXATION, §§ 24.09, 24.36 & n.18.1 (1960).

3 Revenue Act of 1926, ch. 27, §§ 204(c)(1), (2), 214(a)(9), 234(a)(8), 44 Stat. 14, 26, 41.

There were no substantial changes concerning the percentage depletion allowance in the revenue acts from 1928 to 1938. Revenue Act of 1928, ch. 852, §§ 23(1), (m), 114(b), 49 Stat. 1658, 1686; Revenue Act of 1938, ch. 289, §§ 23(1), (m), 114 (b), 52 Stat. 460, 495. The Internal Revenue Code of 1939 incorporated the same provisions. Int. Rev. Code of 1939, §§ 23(1), (m), 114(b), 53 Stat. 14, 45 (1939). And later the basic provisions came into the 1954 Code. See INT. REV. CODE OF 1954, § 613.

4 For a discussion of the meaning of "the gross income from the property," see MONTGOMERY, FEDERAL TAXATION 12.10-15 (39th ed. 1964).

5 INT. REV. CODE OF 1954, § 613(a).

Revenue Code. Prior to 1954 there was no statutory definition of "property." The Revenue Act of 1954 corrected this deficiency,[6] but in the process inadvertently bestowed what later proved to be a substantial tax benefit on the oil and gas industry. By 1963, congressional realization of the extent of the tax benefit led to revision of section 614 in the Revenue Act of 1964.[7] This modification of section 614 has caused much confusion and inconvenience in the industry. As a means of clarifying the concept of "property," this note will trace its development, the problems it has created, and possible resolutions.

I. Historical Treatment of "Property" From 1939-1954

There was no statutory definition of "property" until the 1954 Code went into effect. Until that time the taxpayer was guided solely by the Regulations, General Counsel's Memoranda (G.C.M.), and the judicial decisions. Under the 1939 Code, the Regulations provided an interpretation of the term "property":

> (1) "The property" . . . means the interest owned by the taxpayer in any mineral property. The taxpayer's interest in each separate mineral property is a separate "property"; but, where two or more mineral properties are included in a single tract or parcel of land, the taxpayer's interest in such mineral properties may be considered to be a single "property," provided such treatment is consistently followed.[8]

The Regulations then defined "a mineral property" as "the mineral deposit, the development and plant necessary for its extraction, and so much of the surface of the land only as is necessary for purposes of mineral extraction."[9] The "mineral deposit" was said to refer "to minerals in place."[10] Finally, an interest was any economic interest in minerals in place from which the owner derived income as a result of the severance and sale of the mineral. Out of this income, the owner looked for a return of his capital.[11]

This definition of "property" presented numerous difficulties both to the taxpayer and the Internal Revenue Service. Some problems, not dealt with adequately by the Regulations, involved situations in which a taxpayer had one lease covering two noncontiguous tracts of land but containing a single mineral deposit, or in which a taxpayer acquired several leases covering a single tract of land. To resolve such problems, the Service

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6 Int. Rev. Code of 1954, § 614.

7 Revenue Act of 1964, § 226(a), (b), 78 Stat. 94.

8 Treas. Reg. 118, § 39.23(m)-1(i) (1953). This rule had appeared in earlier Regulations in substantially the same form. See Treas. Reg. 111, § 29.23(m)-1(i) (1941); Treas. Reg. 103, § 19.23(m)-1(i) (1940).

9 Treas. Reg. 118, § 39.25(m)-1(d)(2) (1953).

10 Treas. Reg. 118, § 39.23(m)-1(d)(3) (1953).

11 Treas. Reg. 118, § 39.23(m)-1(b) (1953).

issued G.C.M. 22106.[12] While in accord with the Regulations that two or more separate mineral properties could be considered as a single property provided the treatment was consistent, the G.C.M. declared that no other combination of economic interests was permitted. In support of this declaration, the Service stated:

> The term "property" . . . means each separate interest owned by the taxpayer in each separate tract or parcel of land, whether separated geographically or by conveyancing. If a taxpayer holds several different interests in the same tract, each interest is a separate property.[13]

One element of this rule, namely, separation by conveyancing, meant that the taxpayer had as many separate "properties" as he had leases with different persons.[14] For example, if a taxpayer, *A*, acquired three contiguous tracts of land from three separate owners, he would have three separate "properties." Furthermore, when the interests of the taxpayer were separated geographically, *i.e.*, were noncontiguous, the taxpayer's interests were in separate tracts or parcels of land, and were separate properties.[15] Thus if *A* acquired three noncontiguous plots from one owner in one conveyance for a single consideration, the geographical separation created three separate "properties." Moreover, the last element in the rule stated by G.C.M. 22106 required that "different" interests, for example, oil payments and royalties, in the same tract of land, were also to be considered as separate "properties." [16] This principle may be demonstrated by supposing that *A*, the owner of a certain plot of mineral land, leased one-half of it, and operated the other one-half of it. The working interest and the royalty interest from the lease would then be considered "different" interests, and, *A* therefore would have two "properties."

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[12] G.C.M. 22106, 1941-1 CUM. BULL. 245.

[13] *Ibid.*

[14] *Ibid.*

Cases in which courts have considered this element include: J. T. Sneed, Jr., 40 B.T.A. 1136 (1939), *aff'd*, 119 F.2d 767 (5th Cir.), *cert. denied*, 314 U.S. 686 (1941) (a taxpayer was not permitted to treat the income from numerous leases, producing and nonproducing, and acquired at different times, as though the leases constituted one property); Allie M. Turbeville, 31 B.T.A. 283 (1934), *aff'd*, 84 F.2d 307 (5th Cir.), *cert. denied*, 299 U.S. 581 (1936) (a lessor was not entitled to depletion on bonuses from leases covering nonproductive acreage, and the bonuses could not be combined with the income from leases covering productive acreage); Vinton Petroleum Co., 28 B.T.A. 549, *aff'd*, 71 F.2d 420 (5th Cir.), *cert. denied*, 293 U.S. 601 (1934) (a taxpayer, who had combined the gross income from eight contiguous properties acquired at different times, was required to compute its depletion allowance on the gross income from each separate acquisition).

[15] G.C.M. 22106, 1941-1 CUM. BULL. 245, 247.

For a recent judicial application of this element see Bryant's Estate, 34 T.C. 501 (1960), *aff'd*, 290 F.2d 807 (4th Cir. 1961) (twelve quarries, widely separated geographically, had to be regarded separately).

[16] G.C.M. 22106, 1941-1 CUM. BULL. 245. See also G.C.M. 22332, 1941-1 CUM. BULL. 228 for the Service's treatment of "different" interests. "Different" interests were also created by a complex arrangement in Herndon Drilling Co., 6 T.C. 628 (1946).

The Service was determined to construe strictly the term "property" in accordance with its rulings. A major reason for its refusal to approve the combination of separate economic interests was that each depletable property was also an asset subject to sale or other disposition giving rise to gain or loss. The Service stated that:

> Failure to treat each such separate interest as a separate property would disregard or unduly confuse the administration of the provisions of the Revenue Acts requiring the computation of gain or loss upon the sale of an asset and the provisions distinguishing between ordinary gain or loss and capital gain or loss, taxable at different rates, depending upon the length of time the asset was held.[17]

Taxpayers, however, continually pressed for a liberal interpretation of the "property" concept as was evidenced by their struggle with the Service in the courtroom. In two early cases, *Mascot Oil Co.*[18] and *William Cree*[19], the taxpayer succeeded in merging two "different" interests, but the Service quickly expressed disapproval of the decisions. However, in *Helvering v. Jewel Mining Co.*,[20] the court allowed itself to be guided by the Regulations and judicially established three conditions for combining two mineral properties for depletion purposes. The first condition was that the income from both properties be consistently treated by the taxpayer as arising from a single property. Secondly, the court required the taxpayer to own similar interests, either freehold or leasehold, in both properties. Finally, the two properties had to be included in a single tract or parcel of land.[21]

In *Jewel Mining Co.* the Commissioner claimed a deficiency in the taxpayer's income tax for the year 1936 on the ground that the taxpayer erroneously combined income from two separate properties in computing the depletion allowance. The issue was whether the mineral interest covered by the sublease of which the taxpayer was the sublessor constituted a separate property from the mineral interest on the overlying

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17 G.C.M. 22106, 1941-1 CUM. BULL. 247.

18 29 B.T.A. 652 (1933), *appeal dismissed*, 75 F.2d 1009 (1935). In this case, a lessee, who had developed a property, gave a sublease to the Standard Oil Company of California granting it the exclusive right to drill and explore for oil and gas at a depth below 1600 feet. The bonus, which the lessee received from Standard Oil for the property, was combined by the lessee with the income from his working interest. The Board held that the term "property" meant the land acquired by the lessee under the original lease, so that the combination of the bonus with the income from the working interest was permitted.

19 47 B.T.A. 868 (1942), *nonacq.*, 1943 CUM. BULL. 29. Here, taxpayers were assigned two oil and gas leases plus fractional interests which provided for participation in the working interest. The Board held that there were no essential differences between a lease and a participating interest, when the taxpayer acquired the leaseholds, as well as the fractional interests in rights thereunder sold by the lessee. A merger of the interests was thus effected.

20 126 F.2d 1011 (8th Cir. 1942), *reversing* 43 B.T.A. 1123 (1941).

21 126 F.2d at 1013.

lease which was retained by him. The Board of Tax Appeals concluded that, although the taxpayer had two properties, they could be considered as one since he was consistent in his treatment. On appeal, the court, though agreeing with the Board as to consistency, reversed the decision and held that the two properties could not be combined, since the unity of interest required by the Regulations was not present. The court stated that, since the taxpayer had a working leasehold interest in one mine, and a non-working royalty interest in the mine under the sublease arrangement, the combination of these "different" interests would be contrary to the rules developed by the Service. After the *Jewel Mining Co.* case, the "different" interest concept and the consistency of treatment requirement became solidified in the courts.[22]

The *Berkshire Oil Co.*[23] case provided the Tax Court with an opportunity to interpret the "separate tract or parcel of land" requirement for combining two mineral properties. In that case a taxpayer had acquired four lots by a single lease. Only two of the lots were contiguous on one entire side, while the third lot touched only the corner of the second, and the fourth lot touched the corner of the third. The taxpayer argued that the four lots constituted three properties, *i.e.*, the two contiguous lots constituted one property, and the two lots touching at the corners made up two distinct properties. The Commissioner contended that the four lots constituted a single property "having a unitary basis, which includes the intangible drilling and development costs of all wells drilled on any of the lots, and that a loss deduction may not be taken when a portion of the acreage was abandoned, but must await final disposition of the lease." [24] Although the case did not involve the Code sections on depletion allowances, the court stated that "property" had the same meaning in the "loss" sections as in the depletion sections and held that the two lots which touched only at a common corner were not contiguous.[25] The noncontiguous lots covered in the lease were, therefore, separate tracts or parcels of land. The aggregation of the two contiguous lots was permitted, and the taxpayer was able to deduct his costs as a loss on "a property." [26]

Thus from the 1939 Code sections pertaining to the depletion allowance, and from the interpretation given to these sections by the Service and by the courts concerning the "property" concept, it could be concluded that all contiguous areas contained in a lease or in separate leases[27]

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[22] *E.g.*, Island Creek Coal Co., 30 T.C. 370 (1958) (issue of consistency); Herndon Drilling Co., 6 T.C. 628 (1946) ("different" interests); Clover Splint Coal Co., 15 P-H Tax Ct. Mem. 860 (1946).

[23] 9 T.C. 903 (1947).

[24] *Id.* at 910.

[25] This conclusion was based on the decision in Anvil Hydraulic & Drainage Co. v. Code, 182 Fed. 205 (9th Cir. 1910).

[26] Berkshire Oil Co., 9 T.C. 903, 911 (1947).

[27] The Service has usually considered all contiguous areas contained in separate leases executed at the same time from the same owner as a single property for percentage depletion purposes. This rule now appears in the present Regulations. Treas. Reg. § 1.614-1(a)(3) (1961).

executed at the same time from the same owner constituted a single tract and could be treated as a single property.[28] On the other hand, those interests included in separate leases from separate owners were separate tracts or parcels of land even though the areas were contiguous. And if the taxpayer's interests within the same tract or parcel of land were dissimilar, each dissimilar interest constituted a separate property.

Under these rules, however, certain anomalies existed. For example, if a person, leasing three separate properties, acquired from three separate lessors, transferred his interests to a third person, the transferee could then consider the interests as one property. Although both transferor and transferee possessed the same land, the transferor was considered to have had three "properties" while the transferee had only one.

Another anomalous situation was presented when a previously segregated leasehold interest terminated, and full ownership revested in the lessor. The Service first concluded that in such a case the lessor's interest was a single property.[29] However, a later ruling attempted to distinguish the consequences flowing from different forms of termination by stating that when a lease expired at the end of a contractual term, such termination did not in any way enlarge or alter the other interests or "properties" owned by a taxpayer, but that if the lease interest was forfeited or repurchased by the owner of the land, prior to expiration, the minerals attributable to the former royalty would still have to be considered a separate property.[30] And since the owner had two "different" interests, aggregation was prohibited. Thus even though the legal character of the interests as "lease" and "royalty" had disappeared, the Service insisted on maintaining an artificial separation of the nonexisting interests for tax purposes.[31]

Notwithstanding these artificialities, the oil and gas industry was prospering and, for the most part, satisfied with the definiteness of the existing Regulations. Producers of oil and gas were content to combine contiguous interests within a single lease and to consider the lease as a single "property."

But the definition of "property" used by the Service to tax the oil and gas industry was also applied to the hard mineral industry. Hard mineral producers desired to handle one or several mines as a single property and were thus seeking to obtain either a different definition of property or more liberal aggregation rules. Although largely unsuccessful with the Commissioner, the hard mineral interests, after a series of cases, began to persuade the Tax Court to permit producers to treat as one property mines covering a number of tracts or parcels of land.

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28 Compare text accompanying notes 14-16 *supra*. This aggregation of properties in a single lease can be referred to as the lease-rule. For a discussion of the lease-rule, see *Hearings on the Tax Recommendations of the President Contained in His Message Transmitted to the Congress January 24, 1963 Before the House Committee on Ways and Means*, 88th Cong., 1st Sess., pt. 1, at 116 (revised March 27, 1963).

29 G.C.M. 22106, 1941-1 CUM. BULL. 245, 248.

30 G.C.M. 24094, 1944 CUM. BULL. 250.

31 *Ibid.*

Black Mountain Corp.[32] was one of the early cases in which a combination of two separately conveyed interests was permitted. Over a period of years, the taxpayer had acquired separate contiguous coal properties which were assigned to two separate mines. The two mines, were treated as separate properties by the taxpayer. The Commissioner contended that, according to G.C.M. 22106, each separate acquisition had to be treated as a separate property. The court, however, agreed with the taxpayer and stated that:

> Separate acquisitions can, under proper circumstances, be combined to form one property and, likewise, under proper circumstances, one acquisition may become a part of two different properties for this purpose.[33]

Contrary to the Regulations as construed by the Memorandum,[34] the Tax Court accepted the taxpayer's definition of "property." "Property" was said to mean the economic and practical unit which the taxpayer must use and develop in order to extract a particular block of coal.[35] Thus the development, plant, and surface land necessary for the extraction of a particular block of coal, and whatever portion of the mineral deposit which could properly be mined as a unit were included in the "property." The *Black Mountain* court relied on the *Jewel Mining Co.* case but failed to see the important factual distinctions. In *Jewel Mining* the mine had been obtained by a single lease, while in *Black Mountain Co.* the taxpayer acquired the mine by several leases. The *Black Mountain* court rejected application of G.C.M. 22106 because it thought that it would be difficult and inconvenient for the taxpayer to determine the income from each separate acquisition.[36]

Again, in the 1949 *Amherst Coal Co.* case[37] a court applied the Regulations on depletion contrary to the construction placed upon them by G.C.M. 22106. There the taxpayer mined coal from three mines situated on land covering an area of 4,600 acres and acquired at various times between 1912 and 1940, either in fee or by lease. Because the land was all contained within a single boundary, the taxpayer consistently computed percentage depletion as if its income from mining derived from a single property. The court decided that the taxpayer met all three elements of the test prescribed in the *Jewel Mining Co.* case. The income from the operations was consistently treated as arising from one property, the taxpayer owned the properties either in leasehold or freehold, and lastly, all of the taxpayer's acquisitions were contained within a

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32 5 T.C. 1117 (1945), *nonacq.*, 1946-2 CUM. BULL. 6.

33 5 T.C. at 1121-22.

34 G.C.M. 22106, 1941-1 CUM. BULL. 245.

35 Black Mountain Corp., 5 T.C. 1117, 1120 (1945). The court anticipated what later became known as the "operating unit," see text accompanying note 52 *infra.*

36 5 T.C. at 1120.

37 11 T.C. 209 (1948), *nonacq.*, 1949 CUM. BULL. 5.

single continuous boundary. The court again rejected the Commissioner's contention that according to G.C.M. 22106 each separate acquisition of an interest in each seam of coal, either by lease or in fee, constituted a separate property so that seventeen rather than one property existed. Thus, the courts in dealing with the hard mineral industry departed from the "separation by conveyancing" rule established by the Service.[38]

The above cases demonstrated that the definition of "property" and the aggregation rules as construed by the Service were inadequate, in the courts' view, to meet the demands of hard mineral producers. The Commissioner, nevertheless, was unwilling to accept a mine as a single property if it consisted of several separately acquired leases. When Congress set out to draft the Internal Revenue Code of 1954, the need for clarification or revision of the concept of "property" was stressed by the producers of hard minerals.

Spokesmen for the hard mineral industry asserted before the House Committee on Ways and Means that under the 1939 Code, Regulations, and Rulings, the taxpayer might be required to separate into artificial units, several tracts of land that actually constituted one producing unit. The spokesmen argued that the taxpayer was the person who knew best his operations and what could most appropriately be treated as one producing unit. It was thought completely artificial to treat properties as separate simply because they were acquired at different times.[39]

In its General Report on section 614, the Senate committee discussed the necessity of a statutory definition of "property."[40] One of the problems pointed out was that the definition of property, evolved from the administrative regulations, required the preparation of multiple depletion schedules and computations where a single computation would have served the same purpose.[41] Congress failed to consider, however, those differences between the oil and gas industry and the hard mineral industries which called for separate tax treatment.[42]

II. Internal Revenue Code of 1954, Section 614

Under heavy pressure from hard mineral producers, Congress placed into the 1954 Code the first statutory definition of "property."[43] This

38 See Tennessee Consol. Coal Co., 15 T.C. 424 (1950) (a taxpayer who leased certain "fringe" areas to other operators was able to treat the lands as a single property); Cresson Consol. Gold Mining & Milling Co., 11 T.C. 192 (1948), *appeal dismissed,* 175 F.2d 774 (10th Cir. 1949) ("split-check" leases granted to others did not prevent the taxpayer from considering his holdings as one property); Rialto Mining Corp., 15 P-H Tax Ct. Mem. 496 (1946) (taxpayer was able to treat its two mines as one property even though the land was acquired by several leases).

39 See *Hearings Before the Committee on Ways and Means of the House of Representatives,* 83d Cong., 1st Sess., ser. 18, pt. 13, at 1982-87, 2114-16 (1953) (remarks of Henry B. Fernald, Chairman of the Tax Committee of the American Mining Congress, and Lovell H. Parker, Chairman of the Special Tax Committee of the National Coal Association).

40 S. Rep. No. 1622, 83d Cong., 2d Sess. 80 (1954).

41 *Ibid.*

42 *Id.* at 80-81.

43 Int. Rev. Code of 1954, § 614(a).

definition closely followed the definition used in the 1939 Regulations and succeeding G.C.M.'s, *i.e.*, "each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land." [44] Section 614(a) was not amended by subsequent revenue acts, and remains in the Code at the present time.[45] The Regulations construing section 614(a) define an interest as "an economic interest in a mineral deposit." [46] An economic interest includes "working or operating interests, royalties, overriding royalties, production payments, and net profits interests." [47] The 1954 Regulations state that "the term 'tract or parcel of land' is merely descriptive of the physical scope of the land to which the taxpayer's interest relates, . . . [but] is not descriptive of the nature of his rights or interests in the land." [48] The rule that all the contiguous areas included in a single conveyance constituted a single tract or parcel of land was retained by the new Regulations.[49] These Regulations also retained the rule that separate conveyances from separate owners were separate properties, even though the areas described were contiguous.[50] If it were not for a subsequent subsection, the mere codification of this definition of "property" would have been of little value to the taxpayer and would have only provided the Commissioner with greater authority for his original position. However, any problems that might still have existed under section 614(a) for the producer were greatly alleviated by the broad aggregation rules in section 614(b).

Section 614(b) [51] set forth the most significant modification in the calculation of percentage depletion in the 1954 Code. In an effort to satisfy the demands of the hard mineral producers, Congress permitted the taxpayer to elect to combine two or more separate operating mineral interests to form one aggregation provided that the aggregated operating mineral interests constituted part or all of an operating unit.[52] Those interests not included in the aggregation were to be treated as separate properties.[53] Although only one aggregation of operating mineral interests was allowed in an operating unit, the aggregated operating interests did not all have to be on the same tract or parcel of land or included in contiguous tracts or parcels of land.[54] An "operating mineral interest" was defined as an

[44] See G.C.M. 22106, 1941-1 CUM. BULL. 245-47.

[45] See INT. REV. CODE OF 1954, § 614(a). See generally BREEDING & BURTON, TAXATION OF OIL AND GAS INCOME 194 (1954).

[46] Treas. Reg. § 1.614-1(a)(2) (1961).

[47] *Ibid.*

[48] Treas. Reg. § 1.614-1(a)(3) (1961).

[49] *Ibid.*

[50] *Ibid.*

[51] INT. REV. CODE OF 1954, § 614(b), 68A Stat. 210 (amended by 72 Stat. 1633 (1958), as amended 78 Stat. 94-96 (1964)).

[52] INT. REV. CODE OF 1954, § 614(b)(1)(A), 68A Stat. 210 (amended by 78 Stat. 94-95 (1964)).

[53] INT. REV. CODE OF 1954, § 614(b)(1)(B), 68A Stat. 210 (amended by 78 Stat. 94-95 (1964)).

[54] INT. REV. CODE OF 1954, § 614(b)(1), 68A Stat. 210 (amended by 78 Stat. 94-95 (1964)).

interest, the cost of production of which was taken into account by the taxpayer for purposes of computing the fifty percent limitation on percentage depletion.[55] These interests did "not include royalty interests or similar interests, such as production payments or net profit interests."[56] The latter interests were called "non-operating interests."[57]

The impact of this subsection can only be appreciated when its effect on the basic definition of "property" is examined. The "separation by conveyancing" rule was now of only slight importance, since all acquisitions in the same operating unit could be combined. Likewise, the concept of "geographical separation" was rendered meaningless since lots, whether contiguous or noncontiguous, located in a single operating unit, could be aggregated. The lease, which previously described the limits of an aggregation, was now replaced by the much broader concept of the operating unit. Now instead of preventing the aggregation of all "different" interests, Congress allowed all "operating mineral interests" to be combined and "non-operating interests" to be combined under special circumstances,[58] although the Regulations prohibited the aggregation of operating with nonoperating interests.[59]

Thus the only function of the "property" definition after 614(b) was to aid the taxpayer in determining whether he did, in fact, have separate "properties." Once this determination was made, the taxpayer no longer had to deal with the term "property," since the "operating unit" concept had its own special rules for aggregation. Of course, if any interests were not aggregated under section 614(b), the "property" concept remained applicable to the separate interests.

The net result of section 614(b) was that Congress, in order to resolve the problems of the hard mineral industry, established a new concept of aggregation which enabled the oil and gas industry to aggregate mineral interests on a much broader scale than it had ever previously done. The "operating unit", as construed by the Regulations,[60] contemplated aggregation only of interests which could conveniently and economically be operated together as a single producing unit.[61] Thus, interests geographically widespread were not to be considered parts of the same operating unit merely because one set of accounting records was maintained by the taxpayer or merely because the products of the interest were

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55 Treas. Reg. § 1.614-2(b) (1961).

56 *Ibid.*

57 See Treas. Reg. § 1.614-5(g) (1961).

58 INT. REV. CODE OF 1954, § 614(c), 68A Stat. 210-11 (amended by 72 Stat. 1634 (1958)) (now INT. REV. CODE OF 1954, § 614(e)). Under the section as originally enacted in the 1954 Code, the taxpayer had to prove that undue hardship would result if he could not aggregate nonoperating interests. *Ibid.* The undue hardship requirement is not presently in force. See INT. REV. CODE OF 1954, § 614(e). For a discussion of the present requirements see text accompanying notes 84-87 *infra.*

59 Treas. Reg. § 1.614-2(b) (1961).

60 Treas. Reg. § 1.614-2(c) (1) (1961).

61 See *ibid.*

processed at the same treatment plant.[62] Although operating units varied in size and content from one taxpayer to another, there were certain factors which were indicative of such a unit. Mineral interests were said to be operated together when there were common field or operating personnel, common supply and maintenance facilities, common processing or treatment plants, and common storage facilities.[63] In the case of hard mineral producers, this concept of an "operating unit" was relatively easy to determine. Since the concept was also applicable to the oil and gas industry, however, a problem arose in determining the boundaries of a unit which had never before been recognized by oil and gas producers.

There was continuous disagreement between the large producers of oil and gas and the Internal Revenue Service.[64] While the producers tried to make the operating unit as broad as possible, the Service wanted to restrict its size and content. The large oil and gas producers obtained an appreciable tax benefit from the aggregation rules after agreements were reached with the Service as to the size of the operating unit. By combining those interests which had a high cost of production with those interests which had a low cost of production, the taxpayer was able to overcome the fifty percent limitation and maximize the permissible percentage depletion allowance.

Example:

Corporation *X* has three operating interests within a single operating unit.

	Interests			Aggregation
	A	B	C	A, B, C
Gross Income from the Property	$100,000	$100,000	$100,000	$300,000
Cost of Production	70,000	20,000	35,000	125,000
Taxable Income from the Property	30,000	80,000	65,000	175,000
% Depletion (27½% of gross income but not to exceed 50% of taxable income from the property)	15,000	27,500	27,500	82,500

From this example, it is evident that when the taxpayer made this advantageous aggregation, he was able to deduct 82,500 dollars for depletion instead of the 70,000 dollars which would have been the deductible amount had the interests been treated as separate properties. Thus the larger the operating unit, the better was the taxpayer's opportunity to form beneficial aggregations.

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62 *Ibid.*

63 Treas. Reg. § 1.614-2(c)(1) (1961).

64 Small producers of oil and gas did not have a sufficient number of interests to form large operating units. The conflicts, therefore, over the limits of an operating unit involved for the most part the larger producers.

However, the taxpayer was faced with the problem of determining which properties to aggregate and which to treat separately in order to maximize the depletion allowance. With each operating interest he had to make an election whether or not to aggregate for whichever of the following taxable years was later: (1) the first taxable year beginning after December 31, 1953, or (2) the first taxable year in which the taxpayer made any expenditure for exploration, development, or operation with respect to the separate operating interest after acquisition.[65] Once the election was made, it was binding for all future years.[66] Since the taxpayer had to elect at the exploration stage, it was usually most difficult for him to determine with certainty the future prospects of a potential deposit. The aggregation benefits might, therefore, prove to be short lived so that the taxpayer would have been in a better position had he kept the interests separate.

Example:

Corporation *X*, after making a favorable aggregation the first year, had development expenditures in interest C, and thus the interest was thrown into a loss position.

	INTERESTS			AGGREGATION
	A	B	C	A, B, C
Gross Income from the Property	$100,000	$100,000	$100,000	$300,000
Cost of Production	20,000	30,000	150,000	200,000
Taxable Income from the Property	80,000	70,000	(50,000)	100,000
% Depletion (27½% of gross income but not to exceed 50% of taxable income from the property)	27,500	27,500	0	50,000

Had the taxpayer maintained interests A, B, and C as separate properties he would have had an allowance of 55,000 dollars. But the allowance in the aggregation was only 50,000 dollars because the taxpayer was required to subtract the loss of one interest in the aggregation from the taxable income of the others. Should the losses on this interest within the aggregation persist, the taxpayer would be at a definite disadvantage.

These rigid election rules, however, were rendered ineffective, since at the time the service attempted to clarify the "operating unit" concept, it also permitted new elections to be made to correspond to the more recent interpretation. Because there was a delay in publishing the Regulations

65 See INT. REV. CODE OF 1954, § 614(b)(2), 68A Stat. 210 (amended by 78 Stat. 94-95 (1964)).

66 *Ibid.* However, the interest could later be given different treatment by consent of the Secretary of the Treasury. *Ibid.*

construing section 614, the Commissioner of Internal Revenue issued T.D. 6138, on August 19, 1955, granting each taxpayer the right to revise elections under 614(b) on or before the last day of the third month following the month in which the Regulations under section 614 were published in the *Federal Register*.[67] Since the Regulations were not published until January 10, 1961,[68] the taxpayer had the experience of seven years to help him in his determination of which interests to aggregate. On April 21, 1961, the Commissioner, to supplement T.D. 6138, issued T.I.R. 315 which delegated authority to District Directors of the Internal Revenue to consent to the redetermination of invalid aggregations in the light of the new Regulations. Extensions of time up to six months beyond May 1, 1961, were granted to taxpayers to make elections or revise old ones.[69]

In addition to the fact that the taxpayer, during this period, was able to revise his elections, he was able to change the scope of his operating units, since no agreement had been reached between the Service and the taxpayer as to the outer limits of the unit. Engineer revenue agents in states such as Oklahoma, Texas, and Louisiana accepted the oil field or closely related oil fields as the scope of the operating unit. Other taxpayers were establishing operating units based on:

(i) the entire operations wherever located,

(ii) company districts, or divisions, or

(iii) each state, county, parish, or oil and gas field.[70]

As late as 1964, the Internal Revenue Service still had to issue guidelines to further aid in determining what constituted an "operating unit" in the case of oil and gas properties.[71] The Service declared that "the term operating unit refers to production or extractive activities, as opposed, . . . to drilling and development activities." [72] Thus, the aggregation would be permitted only if the extractive activities indicated that the interests were reasonably and normally operated together as a single property. "Extractive activities . . . [referred to] the day-to-day activities primarily concerned with bringing crude unrefined oil and gas to the mouth of the well." [73] The "operating unit" included those oil and gas operating mineral interests whose extractive activities were under the immediate direction of a single individual.[74] In other words, the operating unit could be no larger than that segment of a taxpayer's producing operations that were supervised by the lowest foreman in his organization.

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67 T.D. 6138, 1955-2 CUM. BULL. 891.

68 See 26 Fed. Reg. 145 (1961).

69 T.I.R. 315, P-H 1961 FED. TAX SERV. ¶ 54,769. The taxpayer had to demonstrate hardship rather than mere inconvenience in meeting the May 1 filing date. *Ibid.*

70 TULANE 11TH INST. ON FED. TAX 246 (1962).

71 Rev. Proc. 64-23, 1964-1 CUM. BULL. 689.

72 *Id.* at 691.

73 *Ibid.*

74 *Id.* at 692.

III. Technical Amendments Act of 1958

While the oil and gas industry and the Service were attempting to find a suitable limit on the operating unit concept, the hard mineral industry was attempting to attain more favorable legislation. The hard mineral producers were not completely satisfied with section 614(b) of the 1954 Code because they wanted to aggregate all of the operating mineral interests in a mine or mines, and to make as many aggregations within a single operating unit as they desired. Section 614(b), however, permitted the taxpayer to form only one aggregation in an operating unit. It was for this reason that Congress, in 1958, added section 614(c) to the Code. The new provision allowed the hard mineral producers to form more than one aggregation of operating mineral interests within an operating unit, so long as each aggregation consisted of all the operating mineral interests which comprised any one mine or any two or more mines.[75]

The 1958 amendments also fulfilled a request made by certain oil and gas producers. Specifically, Congress permitted the oil and gas industry to use the 1954 rules concerning aggregation, or to treat any property as though the 1939 Code continued to apply.[76] Thus the small producers and those larger producers who found it convenient to compute depletion on an individual lease basis could take advantage of the 1939 rules. But most larger producers were not interested in returning to the lease-rule, since the potential tax benefits under the operating unit concept were greater. When in 1963 Congress fully realized this fact, the time was ripe for action.

IV. Revenue Act of 1964

At hearings before the House Committee on Ways and Means, Secretary of the Treasury, Dillon, stated:

> The grouping practices that have evolved in recent years have been used to minimize taxes in a way that does not seem to have been intended by the 1954 legislation and does not accord with sound and ordinary business practices in the oil and gas industry.[77]

Since the 1939 lease-rule worked satisfactorily in the case of oil and gas, but had not proved adaptable to the hard mineral industry, the Secretary recommended repeal of the aggregation section only for the oil and gas industry.[78] The dilution of the fifty percent limitation and the vagueness of the "operating unit" concept gave additional support to his recommendation.[79]

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[75] Int. Rev. Code of 1954, § 614(c), 68A Stat. 210-11 (amended by 72 Stat. 1634 (1958)) (now Int. Rev. Code of 1954, § 614(e)).

[76] Int. Rev. Code of 1954, § 614(d) (added by 72 Stat. 1637 (1958)).

[77] *Hearings on the Tax Recommendations of the President Contained in His Message Transmitted to the Congress January 24, 1963 Before the House Committee on Ways and Means*, 88th Cong., 1st Sess., pt. 1, at 38 (revised March 27, 1963).

[78] *Id.* at 117-18.

[79] *Id.* at 117.

The following table illustrates the extremes to which some producers went in order to obtain the full advantage of the operating unit concept:

Examples of Aggregations Claimed under the Operating Unit Approach (1954-1961) [80]

Examples of operating units claimed	*No. of fields*	*Leases in Unit*			*Length in Miles*	*Breadth in Miles*
		Total	*aggreg.*	*non aggreg.*		
operating unit #1 —includes the whole state of Oklahoma.	138	767	305	462	205	260
operating unit #2 —includes the whole state of Kansas.	127	487	226	261	265	320
operating unit #3 —includes over 50 counties in Texas.	112	549	194	355	285	255
operating unit #4 —includes portions of Arizona, New Mexico and Texas.	45	914	512	402	250	190
operating unit #5 —includes the whole states of Illinois, Indiana and Kentucky.	74	591	432	159	180	90
operating unit #6 —includes over 40 counties in Texas.	72	488	266	222	225	165
operating unit #7 —includes portions of Arizona, Utah, Colorado, New Mexico and Texas.	51	506	192	314	595	180
operating unit #8 —includes over 15 counties in Texas.	108	336	126	210	158	150
operating unit #9 —includes entire Province of Alberta, Canada.	36	unknown		—	575	325

80 *Id.* at 289. (Footnote deleted.) This table was prepared by the Treasury based on the tax returns of several oil companies.

The Secretary also presented two examples in which the taxpayer, by using the operating unit principle and avoiding the net income limitation, had been able to increase greatly his percentage depletion allowance.[81]

Example:

For the years prior to 1954, Companies *X* and *Y* computed percentage depletion on a lease-by-lease basis. When the new aggregation rules went into effect in 1954, the companies began employing the operating unit principle. The following table demonstrates the extent to which the companies avoided the fifty percent limitation, and were able to increase their average effective rate of percentage depletion for later years:

	Tax Year	*Method of Depletion Employed*	*Average Effective Rate of Percentage Depletion*
Company *X*[82]	1952-54	lease-rule	24.9%
	1954	operating units	26.0%
Company *Y*[83]	pre-1954	lease-rule	24.3%
	1955	operating units	25.4%
	amended 1955	larger operating units	26.3%

The oil and gas producers, however, strongly opposed the Secretary's recommendation. Industry spokesmen pointed to the heavy tax burden already borne by the producers[84] and to the likelihood that increased taxes would cause producers to decrease the amount of drilling for new reserves, since the development of some properties would be less attractive.[85] The industry also tried to rebut the Secretary's recommendations concerning the "operating unit" concept. The spokesmen argued that there were already sufficient restrictions placed on the ability of the taxpayer to aggregate since (1) the interests had to be in the same operating unit; (2) an aggregation once made was binding; and (3) only one aggregation was permitted in each unit.[86] The industry also contended that since the

81 *Id.* at 282-83.

82 The percentage depletion allowance for Company *X* was increased by $5,307,782 for 1954 by the use of the operating unit principle. *Id.* at 282.

83 Company *Y* increased its percentage depletion allowance by approximately $10,000,000 by avoiding the fifty percent limitation in changing to the operating unit principle. *Id.* at 283.

84 See *Hearings on H.R. 8363 (Revenue Act of 1963) Before the Senate Committee on Finance*, 88th Cong., 1st Sess., pt. 5, at 2383-84 (1963) (remarks of Dr. Richard J. Gonzalez, Director, Humble Oil and Refining Company).

Dr. Gonzalez pointed out that the taxes on petroleum and its products averaged about $2.64 per barrel of crude oil:

a. Excise taxes on gasoline	$1.95
b. Income tax liability on domestic crude oil production	.48
c. Severance and property taxes on domestic petroleum operations	.21
TOTAL	$2.64

85 See *id.* at 2359-61 (remarks of Dr. Gonzalez); *id.* at 2386-89 (remarks of Wallace W. Wilson, Vice-President, Oil Division of Continental Illinois National Banking & Trust Company of Chicago).

86 See *id.* at 3714 (remarks of Dr. Gonzales).

Service would have to establish a workable definition for the "operating unit" for the years 1954-1963, and since many taxpayers had already settled this issue with the Service, it would be administratively easier to continue the existing aggregations than to dissolve the invalid ones.[87] The partial validity of this argument, however, was overshadowed by congressional concern with lack of uniformity in applying the "operating unit" concept.

A, Revised Section 614(b)

Congress could not be persuaded to keep the "operating unit" concept in effect for the oil and gas industry, and, in 1964, section 614(b) was amended.[88] This section now provides that producers of oil and gas must treat all of their operating mineral interests in a separate tract or parcel of land as one property unless they elect to treat the interests as separate.[89] Thus the "operating unit," as the outer limit of aggregation, was replaced by the separate tract or parcel of land. The amendments to section 614(b) and their application can best be explained by the following example.

A taxpayer has operating interests, A, B, C, D, and E in a single tract or parcel of land. If the taxpayer does not make an election under revised section 614(b)(2), then all of the interests must be combined to form one property. The taxpayer, however, may elect to combine A, B, and C and keep as separate properties D and E. Should a new interest, F, be discovered on the same tract of land, it will be combined with the A, B, C, aggregation unless the taxpayer elects to make it a separate property. F cannot be combined with D or E, for only one aggregation is permitted on a single tract of land.

Section 614(b), however, deals solely with operating mineral interests. The Code contains a separate section applicable to nonoperating mineral interests.[90] This is section 614(e), which permits a taxpayer who "owns two or more separate nonoperating mineral interests in a single tract or parcel of land or in two or more adjacent tracts or parcels of land" to aggregate all such interests in each separate deposit, and to treat them as one property.[91] Adjacent tracts are those "in reasonably close proximity." [92] Aggregation of nonoperating interests is conditioned on proof to the Commissioner that the taxpayer is not motivated chiefly by tax avoidance.[93] Prior to the 1958 amendments, nonoperating interests could only be aggregated after the taxpayer proved that he would sustain "undue

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87 *Id.* at 2401-02.

88 Revenue Act of 1964, § 226, 78 Stat. 19, INT. REV. CODE OF 1954, § 614.

89 INT. REV. CODE OF 1954, §§ 614(b)(1), (b)(2).

90 INT. REV. CODE OF 1954, § 614(e).

91 INT. REV. CODE OF 1954, § 614(e)(1).

92 Treas. Reg. § 1.614-5(d) (1961).

93 *Ibid.*

hardship" if the interests could not be treated as one property.[94] Thus, although the rules for aggregating nonoperating mineral interests have been liberalized, the Commissioner still retains considerable control.

Since nonoperating mineral interests were not included in the "operating unit" concept, only the aggregations of operating mineral interests were affected by the 1964 Revenue Act. If the aggregations made by producers under the "operating unit" concept do not satisfy the requirements of revised section 614(b), the taxpayer is faced with the problem of allocating the basis of a now invalid aggregation to the separated interests. Proposed Treasury Regulations provide two methods of effecting this allocation.[95] The first method, the fair market value rule, requires the taxpayer to multiply "the adjusted basis of the [invalid] aggregation by a fraction the numerator of which is the fair market value of such interest and the denominator of which is the fair market value of such aggregation."[96] For example, suppose an invalid aggregation with an adjusted basis is equal to 12,000 dollars, and the fair market value of the aggregation is equal to 20,000 dollars. Interest A has a fair market value of 5,000 dollars; B, 10,000 dollars; C, 5,000 dollars; computed as follows:

$$\text{Basis to A} = 3{,}000 \qquad \frac{5{,}000}{20{,}000} \times 12{,}000 = 3{,}000$$

$$\text{Basis to B} = 6{,}000 \qquad \frac{10{,}000}{20{,}000} \times 12{,}000 = 6{,}000$$

$$\text{Basis to C} = 3{,}000 \qquad \frac{5{,}000}{20{,}000} \times 12{,}000 = 3{,}000$$

The second means of allocating the basis is known as the allocation of adjustments.[97] Under this method the adjusted basis of an individual interest in an invalid aggregation is the adjusted basis of the interest at the time such interest was first included in the invalid aggregation, adjusted for that portion of those subsequent adjustments to the invalid aggregation which are reasonably attributed to such interest. The adjusted basis of the individual interests cannot exceed the adjusted basis of the invalid aggregation.[98] For example, suppose the cost of interests A, B, and C was 10,000 dollars each, and the total adjustments to the invalid aggregation were 20,000 dollars, allocable to interests A, B and C in the amounts of 3,000 dollars, 12,000 dollars, and 5,000 dollars respectively. This adjustment must be a reasonable allocation that can be attributable to the

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94 Treas. Reg. § 1.614-5(a) (1961).
95 Proposed Treas. Reg. § 1.614-6(a)(2)(ii), 30 Fed. Reg. 2666 (1965).
96 Proposed Treas. Reg. § 1.614-6(a)(2)(ii)(a), 30 Fed. Reg. 2666 (1965).
97 Proposed Treas. Reg. § 1.614-6(a)(2)(ii)(b), 30 Fed. Reg. 2666 (1965).
98 Proposed Treas. Reg. § 1.614-6(a)(2)(ii)(b)(ii), 30 Fed. Reg. 2666 (1965).

individual interests "based on records of production or on any other facts which establish the reasonableness of the determination." [99] The adjusted basis of the invalid aggregation equals 10,000 dollars. When the taxpayer treats A, B, and C as separate interests, their bases will be 7,000 dollars, no dollars, and 5,000 dollars respectively. Their total adjusted bases, computed individually, equal 12,000 dollars. Because the total of the individually adjusted bases equals 12,000 dollars these individual bases will have to be appropriately reduced so that the sum equals 10,000 dollars.[100]

Allocation of bases will not be a pervasive problem, however, since percentage depletion will probably have wiped out any cost basis that may have existed on most of the interests. If little or no basis remains in a now invalid aggregation, most producers will probably not go to the expense of making the necessary allocations. Furthermore, those interests in which cost depletion would have exceeded percentage depletion were probably kept as separate properties by the taxpayer. Should any basis, however, still exist for an invalid aggregation, it will be a difficult task to make reasonable allocations. Thus this area may cause some dispute between the taxpayer and the Service in the future.

B. Unitization or Pooling Agreements (Revised Section 614(b)(3))

Although the operating unit concept has been removed from the Code for the oil and gas industry, Congress did provide the industry with a method of combining the oil and gas interests of different owners in the 1964 amendments. The producers' need for such a method has been increasingly felt in recent years as technological developments have provided opportunities for achieving significant economies in the process of extracting petroleum products. These opportunities arise because oil and gas are located underground in a porous rock reservoir, or common source of supply, and because such a reservoir often lies beneath several separately owned tracts of land. Since production causes the minerals to drain toward the operating well, unitization may be needed during primary recovery to protect the adjacent property owners. After the primary recovery has been completed, the remaining oil can be extracted by secondary means of recovery. Reserves of oil and gas have been greatly augmented with the improvement of secondary means of recovery coupled with the use of unitization agreements. Provision was made for these pooling and unitization agreements in the 1964 amendments, by creating an exception to the rule that only operating mineral interests in each separate tract of land can be aggregated.[101]

The proposed Regulations construing the 1964 amendments state that a unitization or pooling agreement exists, when "two or more persons

[99] Proposed Treas. Reg. § 1.614-6(a)(2)(ii)(b)(i), 30 Fed. Reg. 2666 (1965).

[100] Proposed Treas. Reg. § 1.614-6(a)(2)(ii)(b)(ii), 30 Fed. Reg. 2666 (1965).

[101] Revenue Act of 1964, § 226(b)(3), 78 Stat. 19, INT. REV. CODE OF 1954, § 614(b)(3).

owning operating mineral interests agree to have the interests operated on a unified basis and further agree to share in the production on a stipulated percentage or fractional basis regardless . . . which interest or interests . . . [produce] the oil."[102] Such an agreement can also exist when a taxpayer who holds "mineral interests in several leases . . . [agrees] with his several royalty owners to determine the royalties payable to each on a stipulated percentage basis regardless . . . which lease or leases [produce] the oil."[103]

Under a voluntary or involuntary unitization or pooling agreement, the participating operating interests of a taxpayer are treated as one property with the restriction that, if the plan is voluntary, the participating interests must be "in the same deposit or . . . in two or more deposits, the joint development . . . of which is logical, without taking the tax benefits into account, from the standpoint of geology, convenience, economy, or conservation."[104] Moreover, the interests in a voluntary agreement must be on contiguous tracts of land or in close proximity.[105] These limitations were imposed to prevent development of unitization agreements solely designed to achieve the kind of tax benefits obtained under the "operating unit" rule. It is permissible, however, for a taxpayer to treat those of his interests participating in a unitization agreement as separate properties if he had done so prior to 1964, and if it was proper under the law at the time of the agreement.[106]

Though Congress did benefit the taxpayer by allowing this added amount of aggregation, it also restricted what the pre-1964 cases had allowed. One such case was *Belridge Oil Co. v. Commissioner*.[107] There a taxpayer wanted to take cost depletion on property recently acquired at a high cost. The property was placed in a unitization agreement with another property having no basis, and under the agreement each party was to receive distributions in proportion to the production of each party in the deposit prior to the unitization agreement. The taxpayer took cost depletion on the income derived from the high cost property and percentage depletion on the property without any basis. The Commissioner, however, contended that a tax free exchange had occurred in which two separate properties were exchanged for a single new interest, and that therefore only one method of depletion could be applied to the whole property. The Tax Court, however, held for the taxpayer, and the decision was affirmed by the circuit court. The circuit court stated that no taxfree exchange occurred because unitization was merely an agreement as to how parties would use what they already had.

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[102] Proposed Treas. Reg. § 1.614-8(b)(5), 30 Fed. Reg. 2669 (1965).

[103] *Ibid.*

[104] Proposed Treas. Reg. § 1.614-8(b)(2), 30 Fed. Reg. 2669 (1965).

[105] *Ibid.*

[106] INT. REV. CODE OF 1954, § 614(b)(3)(C).

[107] 27 T.C. 1044 (1957), *aff'd*, 267 F.2d 291 (9th Cir. 1959); *cf.* Earl v. Whitwell, 28 T.C. 372 (1957), *rev'd on other grounds*, 257 F.2d 548 (5th Cir. 1958).

A similar and more recent decision is *Winfield Killam*.[108] In that case the taxpayer owned three separate leases, took percentage depletion on one lease and calculated cost depletion on the other two. In a unitization agreement entered into by the taxpayer in 1954, the three leases were joined. The court held, following the *Belridge* case, that the taxpayer did not lose its right to claim depletion on the separate leases as its separate properties by reason of the agreement. Thus the 1964 Act has eliminated the confusion of the *Belridge* and *Killam* cases for future years, though the courts must still resolve the question for agreements made in past years.

V. Present Status of Property

Although the basic definition of "property" has remained fairly constant since its establishment by the Service in the earlier Regulations and accompanying memoranda, the limits of aggregation underwent sweeping revision in 1954 with the advent of the "operating unit" concept. The enactment of the 1964 Revenue Act marks the return with certain modifications of the 1939 lease-rule and the abrogation of the "operating unit" concept for the oil and gas industry. The present rule, that all of the taxpayer's operating mineral interests in a separate tract or parcel of land must be treated as a single property unless he elects to treat the interests as separate,[109] differs only slightly from the 1939 lease-rule. One modification is that formerly the taxpayer treated his interests in a tract or parcel of land as separate unless he elected to combine, while now he must treat his operating mineral interests as combined unless he elects to keep them separate.[110] And while the former lease-rule applied to the "interests" of the taxpayer, distinguishing between "different" interests, the new lease-rule applies to "operating mineral interests," and distinguishes between "operating" and "nonoperating mineral interests." [111]

The modified lease-rule, however, follows many of the principles established by its predecessor under the 1939 Regulations, and provides that operating mineral interests in one tract of land cannot be combined with those in another tract geographically separated from the former.[112] The separation by conveyancing rule also has retained its vitality and prohibits the aggregation of grants or conveyances from separate persons.[113] Furthermore, operating and nonoperating mineral interests cannot be combined, since they represent "different" interests.[114] Because of these

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108 39 T.C. 680 (1963).

109 Int. Rev. Code of 1954, §§ 614(b)(1), (b)(2).

110 *Ibid.*

111 Int. Rev. Code of 1954, §§ 614(b), (e).

112 Int. Rev. Code of 1954, § 614(b)(1)(B).

113 Treas. Reg. § 1.614-1(a)(3) (1961).

114 Proposed Treas. Reg. § 1.614-8(a)(1), 30 Fed. Reg. 2667 (1965).

similarities between the modified lease-rule and its predecessor, Congress permits a taxpayer who has arranged his interests under the 1939 rules to maintain his arrangement for taxable years after December 31, 1963.[115]

As previously noted, an exception to the modified lease-rule exists in the case of unitization and pooling agreements. The taxpayer must aggregate all of his operating mineral interests that participate in one of these agreements.[116] Therefore, whether the interests are separated geographically or are separately conveyed is of no concrn to the taxpayer. The mere fact of participation establishes the necessity for aggregation.

Re-establishment of the lease-rule, with the above modifications, appears to be the wisest action that Congress could have taken. The rule is the best one for the oil and gas industry, since it is based on a legal form with which the industry is most familiar. Furthermore, the rule can be administered with relative ease, and the industry, in 1939, was content with its definiteness and results. The problems that remain today concerning aggregation rules are the result of the years from 1954 to 1963 during which the "operating unit" concept was in effect. In addition to the natural planning problems that arise whenever a businessman must change a method which he has used and relied on for ten years, the 1964 Revenue Act also forces the industry to confront the problem of disjoining the now invalid 1954 aggregations, and allocating the basis of the invalid aggregations to the separated interests. In reality, since most of the bases of the aggregations, if not all, have been eliminated by the depletion allowances, the taxpayers will not be overburdened by this task.

As a result of the 1964 amendments the taxpayer must also redetermine which properties to combine, and which to keep separate under the modified lease-rule. Data will now have to be collected to help the taxpayer decide the amount of production, operating expenses, drilling costs, etc. attributable to the numerous individual interests that are created. Although these tasks will inconvenience many large producers, Congress has changed the election rules to aid the producers in determining which aggregations to make. The taxpayer can now wait until the year of the first expenditure for drilling or development instead of making the determination at the time of the first exploration expense.[117] This gives the taxpayer extra time to decide which interests should be combined, and which should be kept separated.

The most serious problem facing the producers of oil and gas is settling the issue of defining an "operating unit" for the years 1954-1963. If a producer had aggregated during those ten years, he must still prove that his aggregations were within the letter of the Code. Those who

115 Int. Rev. Code of 1954, § 614(b)(5).

116 Int. Rev. Code of 1954, § 614(b)(3). Section 614(b)(3)(C) of the 1954 Internal Revenue Code, however, allows taxpayer to continue treating separately such interests which for any year before January 1, 1964 the taxpayer properly treated as separate interests.

117 Int. Rev. Code of 1954, § 614(b)(4).

reached an agreement with the Service have discovered that their efforts were short-lived since the aggregation rules no longer apply to them. With the aid of the guidelines recently issued by the Service,[118] however, it is hoped that much of the conflict will be resolved.

Conclusion

Once the burdensome task of breaking up the 1954 aggregations is completed, the modified lease-rule will more realistically represent the financial and physical structure of the oil and gas industry. Furthermore, because of the changes in election procedures and in the handling of unitization agreements, producers will be in a better situation than they were under the 1939 lease-rule. Perhaps, however, one further refinement of the lease-rule could be made to eliminate the existence of an unnecessary distinction. The following hypothetical situation demonstrates the problem that this refinement would be designed to solve.

Suppose that a decedent divided a plot of his land containing a mineral deposit into three separate parts, leaving one part to each of his three sons in his will. Is it possible for a lessee to take leases from the three beneficiaries, and then treat the land covered by the leases as one property? The lessee is unable to consider areas included in separate leases from separate owners as a single tract of land because each lease is a separate property for purposes of computing the depletion allowance. If the lessee, after acquiring the land, sublet the three properties under one sublease, the sublessee would have one tract of land which could be considered as one property. Would it have made a difference if the beneficiaries were each given an undivided one third interest in the property? Since the three beneficiaries own a single plot of land jointly, it is possible that the lessee would be able to consider the plot obtained by the three leases as a single property. A court, not following the Regulations, might overlook the number of conveyances in this situation and direct its attention to the physical unit involved since the leases do not cover separate parts of land, but rather an indivisible part of the same land. The lessee, in order to "lease" the property, is required to obtain three separate leases, but in developing the land it is impossible to determine on whose property the lessee is operating.

Perhaps, it might be more in line with the business structure of the oil and gas industry to make a change in the Regulations in order to avoid the results of the above hypothetical situation. It appears artificial to permit a lessee to treat leases obtained at the same time from a lessor as a single property, while requiring that the lessee treat as separate properties the leases acquired from separate owners covering the identical land. The Regulations construing section 614(a) should also contain a statement providing that leases, which pertain to contiguous plots of land,

118 Rev. Proc. 64-23, 1964 Int. Rev. Bull. No. 22, at 75.

acquired at the same time, from separate persons, and requiring the development solely of a single deposit or solely of deposits common to each lease, constitute a single property. Such a provision would avoid the unnecessary distinctions, and would recognize the unitary operation required in removing oil and gas from a single deposit. The "contiguity" requirement and the "single deposit" requirement will also prevent the taxpayer from taking undue advantage of this rule as he could under the "operating unit" concept, so that no new tax benefit will be given to oil and gas producers.[119] At present, there is no need to add any further incentives in the form of tax benefits to the oil and gas industry's already substantial percentage depletion allowance. This allowance more than adequately fulfills such present requirements as (1) the industry's constant need for new capital to pour back into development and research; (2) compensation of the producers for the high risk element involved in the search for new resources, and (3) provision of a rate of return on invested capital comparable to that of other industries. On the other hand, the enormous growth of the industry and its production of a huge surplus of oil and gas present substantial reasons for declining any further governmental aid.

Fred E. Newberg †

[119] It might prove beneficial for Congress to re-examine the aggregation rules pertaining to the hard mineral producers. Although the percentage depletion allowance is much smaller for these producers than that used for the oil and gas industry, a recent case demonstrates the enormous tax benefits that can be obtained by use of § 614(c) of the 1954 Code, a very liberal section on aggregation which pertains only to the hard mineral industry. See Day Mines, 42 T.C. 337 (1964). Perhaps Congress can justify these tax benefits because it believes that the industry requires incentives to encourage greater development of resources.

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